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In the

Supreme Court of the United States

October Term, 1963

No. 942

THOMAS KERR and BARBARA KERR, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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TO THE HONORABLE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Petitioners, Thomas Kerr and Barbara Kerr, pray that a Writ of Certiorari be issued to review the Judgment of the United States Court of Appeals for the Ninth Circuit, affirming the decision of the Tax Court in favor of the Commissioner of Internal Revenue, entered in the above entitled case on January 3, 1964.

OPINIONS BELOW

The opinion of the Tax Court (*infra*, Appendix 15; R. 110-127) is reported at 38 T.C. 723. The opinion of the Court of Appeals (*infra*, Appendix 35; R. 131-150) is reported at 326 F.2d 225.

JURISDICTION

The Judgment of the Court of Appeals was rendered and entered on January 3, 1964 (R. 151). Jurisdiction of this Court is invoked under the provisions of 62 Stat. 928, 28 U.S.C. § 1254; 62 Stat. 961, 63 Stat. 104, 28 U.S.C. §2101; and 68A Stat. 89D, 26 U.S.C. § 7482.

QUESTIONS PRESENTED

Petitioner, Thomas Kerr,[1] who owned all the capital stock of two corporations, transferred the stock of

1. Barbara Kerr is involved only because a joint tax return was filed for the year involved. Thomas is thus referred to as Petitioner.

one to the other in exchange for a $50,000 note. The questions are:

1. Was the note taxable to Petitioner as a distribution essentially equivalent to a dividend under Sections 304, 302 and related sections of the Code.[2]

2. If the answer is yes, are Sections 304 and 302 unconstitutional?

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

Citations to the constitutional provisions and statutes which this case involves (the pertinent parts of which are set out verbatim in the Appendix, *infra*) are as follows:

Constitution of the United States

Article I, Section 9, Clause 4

Amendment XVI

Internal Revenue Code of 1954

Section 301, 68A Stat. 84

Section 302, 68A Stat. 85

Section 304, 68A Stat. 89

Section 316, 68A Stat. 98

Section 317, 68A Stat. 99

Section 318, 68A Stat. 99

Section 346, 68A Stat. 110

2. All references to sections are to the Internal Revenue Code of 1954 unless otherwise noted.

STATEMENT OF THE CASE

The two corporations involved are herein called "Helix" and "Kerr Grain." Helix was formed in 1947 and engaged in the flour milling business (R. 15, 16, 102 and 112). Kerr Grain was formed in 1955 and engaged in the grain brokerage and grain storage businesses (R. 22, 23, 102, 113 and 114). Petitioner at all times owned all the capital stock of both corporations.

Circumstances existing at the time of organization of Kerr Grain did not permit the operation of its businesses or the ownership of its stock by Helix (R. 22, 23, 102, 103, 112-114). Shortly thereafter and in the same year, 1955, these circumstances changed and compelling corporate business reasons developed for the integration of the two corporations (R. 20-46, 53-65, 69-75, 81-82, 103-106, 109, and 114-118; Exhibits "3-C," "5-E" and "J"). Petitioner thereupon sold all the capital stock in Kerr Grain, for which he had paid $50,000 in cash, to Helix in exchange for its $50,000 promissory note (R. 50-54, 104 and 117). The Petitioner did not report any income from the transaction (R. 104 and 119).

The Commissioner of Internal Revenue determined that the note constituted a dividend to Petitioners from Helix, increased Petitioners' income by the principal amount of the note and assessed a deficiency against Petitioners (R. 97-98 and 119). The Commissioner

claimed that the transaction was a "brother-sister redemption" which by virtue of Section 304 was equivalent to a distribution by Helix in redemption of its own stock, and that such distribution constituted a dividend to Petitioners because the distribution did not qualify for treatment under Section 302 as an exchange in payment for the stock (a capital gain transaction).

Petitioners conceded that Section 304 permitted the Commissioner to consider the transaction as though Helix had redeemed its own stock, but contended that Section 304 as so applied in conjunction with Section 302 and related sections was unconstitutional. The Petitioners also claimed that the distribution qualified as payment in exchange for the stock under Section 302 because it satisfied the general test of being "not essentially equivalent to a dividend" under paragraph (b) (1) of that Section. Petitioners asked the Tax Court of the United States to resolve the dispute with jurisdiction granted by Sections 6213, 6214 and 7442 (R. 92-99).

The Tax Court paid scant attention to Petitioners' constitutional argument and merely skimmed the surface of the morass created by the case law, under both the 1939 and 1954 Codes, in an attempt to determine whether the transaction was or was not essentially equivalent to a dividend (R. 110-127). Its opinion reveals that it never came to grips with the problem but attempted to find a solution by a perfunctory applica-

tion of as many rules as it could find. It paid particular attention to certain criteria expressed by Barnes, J., in *Earle v. Woodlaw*, 245 F.2d 119 (9th Cir., 1957), *cert den.* 354 U.S. 942, decided under the 1939 Code. In this approach the Tax Court fell into error because it weighed matters which were not pertinent under the 1954 Code and should not have been considered.

The United States Court of Appeals for the Ninth Circuit on appeal from the decision below affirmed (R. 151). The opinion by Judge Barnes (R. 131-150) corrected some of the errors in finding on subsidiary facts but nonetheless followed substantially in the footsteps of the Tax Court. The Court of Appeals, like the Tax Court, failed to see that, or even to inquire whether, the changes in the 1954 Code require the determination of essential dividend equivalence to be made by different standards than under the 1939 Code, and failed to answer the important questions concerning the application of these sections of the 1954 Code which your Petitioners ask this Court to consider.

REASONS FOR GRANTING THE WRIT

This case raises important questions of federal law which have not been, but should be, decided by this Court.

1. The fundamental question is whether Congress can convert a return of capital into income for purposes

of income taxation by the simple device of legislative definition, and thus legislate the Constitutional limitation out of existence. If Congress cannot so act, then Section 304 as applied here is unconstitutional.

Congress and the courts have long recognized that the redemption of stock by a corporation can be used as a device to distribute a dividend in the guise of a capital transaction. For example, a sole stockholder who gives up shares of stock to the issuer corporation has literally given up nothing but the paper represented by the certificates. His ownership of the corporation is in no way diminished, and he has in fact exchanged nothing but paper for the property received. Such distributions in corporate redemptions were, therefore, prior to the 1954 Code taxed as ordinary income as being essentially equivalent to a dividend. Section 115(g), Internal Revenue Code of 1939.

Although the Commissioner had attempted to classify an exchange of the kind involved in this case as a redemption subject to dividend treatment under the 1939 Code, he was notably unsuccessful. *C.I.R. v. Pope*, 239 F2d 881 (1st Cir., 1957). However, when Congress adopted the 1954 Code it added a new provision, Section 304, which gave to the Commissioner what the courts would not—it purported to make an exchange of stock in a brother-sister corporation situation equivalent, for income tax purposes, to the redemption of stock by a

single corporation. In so doing Congress ignored substantial differences between the two situations, which can be readily demonstrated.

The sole stockholder of the A and B Corporations who exchanges all his stock in A for property of B exchanges property for property. Unlike the stockholder in our first example, this one does in fact give up something for the property he receives. He no longer owns A—B does. A stockholder of a corporation is not the owner of the property of the corporation. *Klein v. Board of Tax Sup'rs of Jefferson County, Ky.*, 282 U.S. 19, 24 (1930); 1 FLETCHER, CYCLOPEDIA PRIVATE CORPORATIONS, § 31; BALLANTINE ON CORPORATIONS (REV. ED., 1946), § 119. Most important, the Internal Revenue Code itself recognizes the distinction. The very parts of the Code with which we are concerned, the sections on corporate distributions, exist upon the premise that a stockholder does *not own* the property of the corporation. If this were not true, this case wouldn't be here, because there couldn't be any dividend to be taxed.

It is no answer to say as the Tax Court (*infra*, Appendix 34) and the Court below (*infra*, Appendix 61) have said that even though Congress may have been wrong in Section 304, no harm results because the distribution must still be equivalent to a dividend before it can be taxed as such. Such an answer must proceed on

the premise that the transaction can give rise to a dividend in the first instance, without benefits of fictions such as "essential equivalence." If the premise is false, then no basis exists for determining whether the distribution is or is not essentially equivalent to a dividend.

The Petitioner having parted with the ownership of the Kerr Grain stock, it necessarily follows that the property received by him must be a return of his capital or investment in such property, to the extent of his cost of such investment, and is not "income." This return of capital is therefore not within the exception created by ~~the~~ Sixteenth Amendment and may not be taxed under the income tax laws. *Southern Pacific Company v. Lowe*, 247 U.S. 330 (1918); *Comm'r. v. Meyer*, 139 F.2d 256 (6th Cir., 1943). If Sections 304 and 302 of the Code permit the taxation of this return of capital as income, as contended by the Commissioner, such sections so applied are not within ~~the~~ Sixteenth Amendment and are in contravention of Article 1, Section 9, Clause 4, of the Constitution. *Eisner v. Macomber*, 252 U.S. 189 (1920); *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

2. When is a corporate distribution "not essentially equivalent to a dividend"? The answers which the courts have given to this important question as Congress posed it in the 1954 Code in Section 302(b)(1) have furnished little guidance to taxpayers or to the Commissioner.

The background for this question is summarized nicely in *McGinty v. C.I.R.*, 325 F.2d 820, 821 (2nd Cir., 1963), as follows:

> "Prior to 1954 the question whether a redemption of stock was taxable as a dividend had been a difficult and vexing one under the general language of Section 115(g) of the 1939 Code. In an effort to promote greater certainty in the area, Congress made several changes in the comparable provisions under the 1954 Code. Where, under the 1939 Code, changes in both the shareholder's relation to the corporation and in the scope of the corporation's activity were held relevant to the question of dividend equivalence, it is clear that under § 302 of the 1954 Code only the former are relevant. 'Corporate contraction' is to be considered in determining whether a distribution in redemption of stock is a partial liquidation under § 346. Furthermore, if the distribution meets the conditions of § 302 (b) (2)-(4), a shareholder may be assured that the redemption will be considered a sale or exchange without any need to consider whether it is 'essentially equivalent to a dividend.' However, the vaguer phrase continues to appear in the statute, in § 302 (b) (1), along with an admonition not to consider the failure to qualify under the so-called 'safe harbors' as bearing on the question of dividend equivalence."

This question is important because the answer to it determines whether a corporate distribution is given capital gain or ordinary income treatment. The Revenue Code poses the question not only in Section 302 but in Section 346 (partial liquidation) and in Section 355 (distributions of stock and securities of a controlled

corporation) and Section 356 (receipt of additional consideration in a tax free exchange). See *Ross v. U.S.*, 173 F. Supp. 793, 797 (C.C., 1959).

The thirty-eight cases which have involved this question in the short period since the adoption of the 1954 Code and the over two hundred cases in which it was answered under prior law further demonstrate the importance of the question.

That the "vexing question" (or the "nightmarish problem" as characterized by some, *Wilson v. U.S.*, 154 F. Supp. 341, 342; aff'd 257 F.2d 534 (2d Cir., 1958)) existing under the 1939 Code continues under the 1954 Code was recognized in *Ballenger v. U.S.*, 301 F.2d 192, 194 (3rd Cir., 1962) where the court approached the question as a "morass created by the decisions" and concluded:

> "The success of the effort to clarify the law in this area would have been unquestioned had not this vague negative test been included in the 1954 Code, thus re-injecting the confusion theretofore developed by the case law which has attempted to interpret the phrase 'not essentially equivalent to a dividend.'"

The outline of the decisions in the various circuits, in the Court of Claims, and in the Tax Court, which is appended hereto (*infra* Appendix 72), reveals the nature of the morass. The best we can do to rationalize

these decisions is to place them in two categories as did the court below. These are as follows:

1. Strict Net Effect

The test of equivalence to a dividend is whether the distribution was substantially disproportionate among stockholders. Under this test no other factors are considered and a pro rata redemption can never qualify. In this category would be placed the Second and Third Circuits and perhaps also the First Circuit and the Court of Claims. The Second Circuit apparently considers this as a question of law and the other two as a question of fact.

2. Flexible Net Effect

No one single test is decisive but the solution is to be determined as a question of fact by applying certain "judicial" or "evidentiary" criteria. The usual criteria are those listed by the courts below as follows:

> "Did the corporation adopt any plan of contraction of its business activities; did the transaction actually result in a contraction of the corporation [sic] business; did the initiative for the corporate distribution come from the corporation or the shareholders; was the proportionate ownership of stock by the shareholders changed; what were the amounts, frequency, and significance of dividends in the past; was there a sufficient accumulation of earned surplus to cover distribution or was it partly from capital and was there a bona fide corporate business purpose for the distribution?" (R. 138)

Within this category we group the cases which give equal weight to all the criteria with cases placing greater weight on business purpose or on the substantially disproportionate nature of the transaction. Most of the latter cases seem to give primary weight to the last factor. All other circuits than the three mentioned above as well as the Tax Court appear to fall within this category.

* * * * * * *

The first test is plainly wrong because it writes Section 302(b)(1) out of the Code and leaves only the "safe harbors" of (b)(2), (3) and (4). Such a test completely ignores the express instruction of Congress in (b)(5) and the legislative history of this section. If Congress had wished to leave the matter to be determined by the strict net effect test it could have left this section of the Code as it was when it passed the House (H. Rept. No. 1337, 83 Cong. 2nd Sess., 3 U.S. Cong. & Adm. News 4017, 4216 (1954)), and the Senate version (See S. Rept. to accompany H.R. 8300, 83 Cong. 2nd Sess., 3 U.S. Cong. & Adm. News 4621, 4876, 4877 (1954)) would not have been accepted in conference (See H. Rept. 2543, 83 Cong. 2nd Sess. (1954), 3 U.S. Cong. & Adm. News 5280, 5293 (1954)).

The decisions under the 1954 Code which fall into the second category of cases are also contrary to the

Code. All of these cases reach their result by weighing criteria developed under the 1939 Code, which Congress deliberately excluded from the question of dividend equivalence under the 1954 Code. "Corporate contraction" and the "safe harbors" were all criteria developed under prior law. As the quotation from *McGinty* demonstrates, Congress codified these criteria as separate tests independent of the question of dividend equivalence. Despite this the courts, including the court which decided *McGinty*, have taken these codified criteria into account in deciding the question of dividend equivalence under Section 302(b)(1). In only one case to our knowledge, the recent decision of the Tax Court in *Sorem*, 40 T.C. No. 25 (1963), was this question of the differences between the 1939 Code and the 1954 Code met head-on. Although we urged this point on both courts below, neither of them chose to express themselves on it.

Petitioners respectfully submit that the confusion created by the Commissioner and the courts in the determination of this question has continued long enough and that this is an appropriate case for this court to establish some ground rules under which the question can be decided in the future by the use of standards pertinent to the 1954 Code.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the Petition for Writ of Certiorari should be granted.

Dated: Portland, Oregon, March 20, 1964.

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APPENDIX

To

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

A. OPINIONS BELOW

38 T.C. No. 73

1. TAX COURT OF THE UNITED STATES

THOMAS KERR AND BARBARA KERR, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 89256. Filed August 27, 1962.

Petitioner owned 100 percent of the stock of X and Y corporations. On October 24, 1955, petitioner sold his Y corporation stock to X corporation for $50,000.

Held: The amount received by petitioner is to be treated as a distribution in redemption of the stock of X corporation under sec. 304, I.R.C. 1954.

Held further: The redemption by X corporation of petitioner's stock in Y corporation was a redemption essentially equivalent to a dividend under sec. 302, I.R.C. 1954.

Held further: An income tax imposed on a distribution which is essentially equivalent to a dividend is not repugnant to art. I, sec. 9, of the Constitution.

John P. Apicella, Esq., and *Guy J. Rappleyea, Esq.*, for the peteitioners.

John D. Picco, Esq., for the respondent.

FAY, *Judge:* Respondent has determined a deficiency in the income tax of petitioners for the year 1955 in the amount of $26,036.45. The basic issue presented for decision is whether the amount received by petitioners from a corporation whose outstanding capital stock was owned by petitioners, in exchange for 100 percent of the outstanding capital stock of another corporation owned by petitioners, is taxable as a distribution essentially equivalent to a dividend pursuant to the provisions of sections 302 and 304 of the Internal Revenue Code of 1954.[1]

If the answer to this question is in the affirmative, the petitioners contend that sections 302 and 304 of the Code are unconstitutional in that they cause the imposition of a direct property tax not apportioned among the several States as required by article I of the Constitution of the United States.

FINDINGS OF FACT.

Some of the facts are stipulated and are incorporated herein by this reference.

The petitioners are Thomas Kerr and Barbara Kerr, husband and wife. Their residence was in Portland, Oregon, and they filed a joint income tax return with the district director of internal revenue at Portland,

1. Unless otherwise indicated, all Code references are to the I.R.C. 1954.

Oregon, for the year 1955. (For convenience, Thomas Kerr will hereinafter be referred to as the petitioner.)

Petitioner's family has been engaged in the grain and milling business in Portland and the Pacific Northwest area since before the turn of the century. The petitioner entered the employ of the family grain business, known in later years as Kerr Gifford and Co., Inc., upon his graduation from college in 1932, and he has been engaged in the grain business and related activities continually since that date to the present. Kerr Gifford & Co., Inc., was acquired by Cargill, Incorporated, in June 1953, and petitioner thereafter entered the employ of the latter corporation as an executive.

In 1947 petitioner organized the Helix Milling Company, an Oregon corporation, (hereinafter referred to as Helix) for the purpose of engaging in the business of milling and selling flour. The outstanding stock of Helix, consisting of 100 shares, $100 par value stock, was issued to petitioner in exchange for the mill property. Since Helix's incorporation, petitioner has been its president, its chief executive officer, and a director.

Helix, after its incorporation, was operated by Kerr Gifford and Co., Inc., and later by Cargill, Incorporated, under an arrangement whereby the latter corporations handled the financing of Helix's operations in return for a share of its profits. Helix produced flour almost

exclusively for overseas markets in the Far East. In early 1954 in an effort to improve and stabilize its income and to expand its operations, Helix commenced construction of a modern grain elevator as an adjunct to its flour mill. To finance this facility Helix borrowed $200,000 from the United States National Bank of Portland (hereinafter referred to as the Portland bank) on a ten-year term loan secured by a first mortgage on the grain elevator. The petitioner gave his personal guaranty to the bank as additional security for the construction loan. The grain elevator was completed sometime around the end of 1954.

During this same period Cargill, Incorporated, pursuant to its arrangement with Helix, advanced substantial sums to Helix for working capital and for use in connection with the construction of the grain elevator.

Helix made a net profit before income tax deductions of $43,438.90 during its fiscal year ended June 30, 1954. The minutes of the special meeting of the directors of Helix held on June 29, 1954, provided, in part, as follows:

> The Board of Directors expressed their unanimous approval of the company's past operations and of the policies of the management which have produced the present satisfactory condition of the company.

The minutes also noted that no officers' salaries had heretofore been fixed or paid because of the other financial requirements of the company. A resolution was then unanimously adopted whereby a salary of $9,000 was established for the petitioner for the fiscal year ended June 30, 1954, and was made payable in cash as of June 30, 1954.

In November 1954 petitioner had a meeting with representatives of Cargill, Incorporated, and was informed by them that his employment with Cargill was to be terminated within the next several months. However, nothing was said at the meeting regarding the status of the financing arrangement between Cargill and Helix.

As a result of this meeting, petitioner realized that he would have to seek other means of livelihood, since his salary from Cargill, Incorporated, was his principal source of income. Because the Northwest area was encountering a problem regarding the storage of Government surplus grains, or so petitioner believed, petitioner decided to go into the grain storage business. On January 19, 1955, petitioner organized the Kerr Grain Corporation for the purpose of engaging in the grain brokerage and grain storage business. In forming Kerr Grain, petitioner was hopeful that the corporation would be able to obtain business from the Federal Government. Petitioner was aware that, in the absence

of such business, the corporation would experience difficulty. The outstanding stock of Kerr Grain consisted of 5000 shares, $100 par value stock, all of which was issued to petitioner at the time of organization for $50,000 in cash. The petitioner at all times pertinent to this proceeding has been president and chief executive officer of Kerr Grain.

Even though petitioner's employment with Cargill, Incorporated, was to be terminated, Cargill Incorporated, was still interested in the operation of Helix and offered to make additional loans to Helix in return for certain sales and competitive concessions by petitioner. The offer by Cargill was made before its president learned that petitioner had organized the Kerr Grain Corporation. Upon learning of the formation of Kerr Grain, Cargill's president notified petitioner that unless petitioner halted his plans to go into the grain storage business the arrangement between Cargill and Helix would be terminated and Helix would have to repay its current indebtedness to Cargill.

Petitioner contacted the Portland bank and was able to secure loan commitments which would be sufficient to liquidate the Cargill indebtedness, which by this time totalled approximately $325,000. Petitioner then notified Cargill that he was going to pay off its loans. In order to obtain the necessary funds, petitioner executed personal notes to the Portland bank totalling $150,000

and pledged as security for said loans his expected inheritance from the estate of a deceased relative. After petitioner obtained the money from the Portland bank, he loaned the money to Helix and received Helix's demand promissory notes for $150,000. By March 1955 Helix had succeeded in paying off its indebtedness to Cargill.

Due to the fact that several months elapsed between the time Helix first purchased the wheat and the time it received the proceeds from the sale of its flour, Helix usually found itself in a tight working capital position. Consequently, even after liquidating the Cargill loans, Helix found it necessary to borrow money for working capital purposes, and since the aggrement with Cargill was no longer in effect Helix had to turn to other sources, notably the Portland bank, for funds. The Portland bank permitted Helix to borrow up to $500,000 for operating purposes. However, since the Portland bank considered the business of Helix to be hazardous and from a financial statement point of view considered Helix to be a marginal credit risk, it required the personal guaranty of petitioner to the extent of $300,000 on all operating loans to Helix.

As of June 30, 1955, Helix had total assets of $701,499, total liabilities of $474,448 and earned surplus of $130,051. For its fiscal year ended June 30, 1955, Helix sustained a net loss of $12,198.89.

Kerr Grain commenced operations in January 1955 and derived the principal part of its income in 1955 from the grain storage business. It did not become active in the grain merchandising business until 1956. As of June 30, 1955, the end of its first fiscal year, Kerr Grain had total assets of $266,148 and total liabilities of $218,034. For its first fiscal year, Kerr Grain sustained a net loss of $1,886.40.

Following its organization, Kerr Grain lacked sufficient working capital to finance its operations and was forced to seek outside financing. The Portland bank extended it a credit ceiling of $150,000, and as in the case of Helix and for the same reasons, required the personal guaranty of petitioner as security. Helix also advanced various sums to Kerr Grain and paid its office expenses until August 1955.

The grain storage business in the northwestern United States turned out to be extremely competitive with practically every large grain firm taking part in the storage business. In addition, a below-average wheat crop in 1955, coupled with heavy export activity by the Federal Government, reduced the amount of wheat available for storage purposes. As a result of this hazardous business situation, the board of directors of Kerr Grain resolved in August 1955 that the company would "conserve its assets and not undertake any new commitments of any kind without the approval of the Board."

On August 24, 1955, petitioner reported to the board of directors of Helix that, except for the mortgage indebtedness to the Portland bank, the company had paid off all its borrowings from the bank as of August 22, 1955, and that since then it had borrowed an additional $40,000 on short term for current purposes. Petitioner admitted that borrowing was considered to be inherently involved in the type of business in which Helix was engaged.

By the fall of 1955 Kerr Grain's business began to improve, and as of October 24, 1955, Kerr Grain had a net profit from operations of $113,393.38. At about this time, the Portland bank agreed to finance certain short term commitments contemplated by Kerr Grain in excess of its original credit ceiling of $150,000. Although the financial position of Helix and Kerr Grain had improved, the Portland bank still required the personal guaranty of petitioner up to a specified amount on all operating loans made to both companies.

On October 24, 1955, following discussions with his attorneys, accountants and representatives of the Portland bank, petitioner at a meeting of the board of directors of Helix submitted a proposal to the board providing for the sale by petitioner to Helix of petitioner's capital stock interest in Kerr Grain. The purchase price was to be $50,000. The board voted to accept petitioner's proposal. Following the acceptance of his offer by the

board of directors, petitioner conveyed all of the outstanding stock of Kerr Grain to Helix and received, in return, the promissory note of Helix payable in installments of not less than $10,000 per year and bearing interest at the rate of 5 percent per annum on the unpaid balance. The note was secured by the pledge to petitioner of the capital stock of Kerr Grain.

Petitioner's basis for the Kerr Grain stock on October 24, 1955, was $50,000. The stock had a book value on that date in excess of $100,000 and a fair market value in excess of $50,000.

Helix had an earned surplus of approximately $130,000 as of June 30, 1955, and as of October 24, 1955, its earned surplus was in excess of $50,000.

At the board meeting of October 24, 1955, petitioner reported to the directors of Helix that the Portland bank had granted to Helix an open line of credit in the amount of $100,000 and a $50,000 additional line of secured credit. As of October 24, 1955, Helix owed the Portland bank $30,000 against the open line of credit.

The Portland bank did not request that petitioner transfer his Kerr Grain stock to Helix; they did not request that the two companies be consolidated; and they did not require petitioner to transfer the Kerr Grain stock to Helix as a condition precedent to future financing. However, representatives of the Portland

bank did inform petitioner during their earlier discussions that the contemplated stock transfer may have "certain advantages—both credit-wise and tax-wise." After the sale of the Kerr Grain stock to Helix, the Portland bank continued to require petitioner's personal guaranty on all operating loans it made to both Helix and Kerr Grain.

Following the sale of the Kerr Grain stock to Helix, no curtailment of either corporation's activity was undertaken. In fact, following the sale, Kerr Grain expanded its business quite materially while Helix maintained its business on a fairly even keel until 1957 when it, too, expanded its operations.

Neither Helix nor Kerr Grain declared or paid a dividend prior to December 14, 1955. On December 14, 1955, Kerr Grain declared and paid a dividend of $33,500 to Helix. On the same date Helix paid an identical amount to petitioner, charging it to an account designated as "Notes Payable to Thomas Kerr."

On June 27, 1956, the board of directors of Kerr Grain declared a cash dividend in the amount of $16,500 to be paid on or before June 30, 1956. On June 27, 1956, the board of directors of Helix passed resolutions providing for the payment of bonuses totalling $13,000 to several of the Helix employees. The bonuses were to be paid on or before June 30, 1956.

For the fiscal year ended June 30, 1956, Kerr Grain and Helix filed a consolidated income tax return.

On petitioner's income tax return for the year 1955 no statement or information was submitted with regard to the sale of petitioner's Kerr Grain stock to Helix. The Commissioner in his notice of deficiency for that year determined that the amount of $50,000 received by petitioner from Helix was taxable as dividend income.

OPINION.

This case presents the issue whether the amount of $50,000 received by petitioner in 1955 from Helix was taxable as dividend income, as determined by the respondent. The respondent maintains that the transfer of Kerr Grain stock to Helix by petitioner constituted a redemption under section 304(a)(1)[2] and that, consequently, the entire amount received by petitioner was taxable as a dividend pursuant to the rules of sections

[2] SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

(a) Treatment of Certain Stock Purchases.—

(1) Acquisition by Related Corporations (Other than Subsidiary).—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

301 and 302.[3] Petitioner concedes that the transaction falls within the purview of section 304(a)(1) and admits that the specific requirements for qualifying the transaction for capital-gain treatment under section 302(b)(2), (3) and (4) are not met. Petitioner contends, however, that the redemption is not essentially equivalent to a dividend within the meaning of section 302(b)(1).

It is recognized in the case law and in the regula-

[3] SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) In General.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . . . . .

(c) Amount Taxable.—In the case of a distribution to which subsection (a) applies—

(1) Amount Constituting Dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

. . . . . .

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges.—

(1) Redemptions not Equivalent to Dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially Disproportionate Redemption of Stock.—

(3) Termination of Shareholder's Interest.—

(4) Stock Issued by Railroad Corporations in Certain Reorganizations.—

(5) Application of Paragraphs.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account.

(c) Constructive Ownership of Stock.—

(1) In General.—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) . . . [Not relevant to this case.]

(d) Redemptions Treated as Distributions of Property.—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

. . . . . .

tions that the question whether a distribution is essentially equivalent to a dividend depends on the facts and circumstances of each case. *Earle v. Woodlaw*, 245 F. 2d 119 (C.A. 9, 1957), certiorari denied 354 U.S. 942 (1957); *Standard Linen Service, Inc.*, 33 T.C. 1 (1959); section 1.302-2(b), Income Tax Regs. Although the cases on this point have failed to lay down a sole decisive test, *Flanagan v. Commissioner*, 116 F. 2d 937, 939 (C.A.D.C. 1940), affirming a Memorandum Opinion of this Court, they have established certain judicial criteria which have proven useful in determining the net effect of the distribution which, in actuality, is the fundamental question. *Flanagan v. Commissioner*, *supra*; *Geneva Heman*, 32 T.C. 479 (1959), affd. 283 F. 2d 227 (C.A. 8, 1960); *Ferro v. Commissioner*, 242 F. 2d 838 (C.A. 3, 1957), affirming a Memorandum Opinion of this Court; and *John A. Decker*, 32 T.C. 326, 330 (1959), affd. per curiam 286 F. 2d 427 (C.A. 6, 1960).

Among these criteria are: Did the corporation adopt any plan of contraction of its business activities; did the transaction actually result in a contraction of the corporation business; did the initiative for the corporate distribution come from the corporation or the shareholders; was the proportionate ownership of stock by the shareholders changed; what were the amounts, frequency and significance of dividends in the past; was there a sufficient accumulation of earned surplus to

cover distribution or was it partly from capital; and was there a bona fide corporate business purpose for the distribution. *Flanagan v. Commissioner*, *supra*; *Earle v. Woodlaw*, *supra*; and *Geneva Heman*, *supra*. It is to be noted that while these criteria materialized for the most part in cases construing section 115(g) of the Internal Revenue Code of 1939, Congress has expressed a desire that they be made applicable to cases arising under section 302(b)(1) as well. S.Rept. No. 1622, to accompany H.R. 8300 (Pub.L. 591), 83d Cong., 2d Sess., pp. 233, 234 (1954).

In applying these criteria to the facts in this case, we find ample evidence to support the respondent's determination that the net effect of the distribution to petitioner amounted to a taxable dividend. There was no manifestation by Helix or Kerr Grain of any policy or plan of contraction of their respective businesses; on the contrary, Kerr Grain expanded its activities quite materially after the sale and Helix maintained its business on an even keel until 1957, when it, too, expanded its operations.[4] The initiative for the stock transaction came from petitioner.[5] At the time of the transaction,

4 *Ferro v. Commissioner*, 242 F. 2d 838 (C.A. 3, 1957), affirming a Memorandum Opinion of this Court, *Smith v. United States*, 121 F. 2d 602 (C.A. 3, 1941), *Thomas G. Lewis*, 35 T.C. 71 (1960).

5 *Bazley v. Commissioner*, 155 F. 2d 237 (C.A. 3, 1946), affirming 4 T.C. 807 (1945), affd. 331 U.S. 737 (1947); *James F. Boyle*, 14 TC. 1382 (1950), affd. 187 F. 2d 557 (C.A. 3, 1951), certiorari denied 342 U.S. 817, (1951); *Pacific Vegetable Oil Corp. v. Commissioner*, 251 F. 2d 682 (C.A. 9, 1957), reversing 26 T.C. 1 (1956); *Commissioner v. Roberts*, 203 F. 2d 304 (C.A. 4, 1953), reversing 17 T.C. 1415 (1952).

Helix had accumulated earnings and profits available for the payment of dividends.[6] Prior to the stock transaction Helix had never paid a cash dividend.[7]

In *Ferro v. Commissioner*, *supra*, the court stated:

> The declaration of a true dividend leaves the ownership and control of a corporation unaffected. Where a distribution of corporate assets likewise leaves proportionate interests unchanged, that circumstance has been termed "the most significant factor in finding dividend equivalence."

In the instant case, prior to the stock transfer petitioner owned all the outstanding stock of Helix and all the outstanding stock of Kerr Grain. Applying the constructive stock ownership rules of section 318(a)(2)(C),[8] petitioner continued to own 100 percent of the

6 *Rheinstrom v. Conner*, 125 F. 2d 790 (C.A. 6, 1942), affirming 33 F. Supp. 917 (D. Ohio 1940), certiorari denied 317 U.S. 654 (1942); *Earle v. Woodlaw*, 245 F. 2d 119 (C.A. 9, 1957), certiorari denied 354 U.S. 942 (1957); *Geneva Heman*, 32 T.C. 479 (1959), affd. 283 F. 2d 227, (C.A. 8, 1960); *Flanagan v. Commissioner*, 116 F. 2d 937 (C.A.D.C. 1940), affirming a Memorandum Opinion of this Court.

7 *James F. Boyle*, *supra*; *Flanagan v. Commissioner*, *supra*; *Thomas G. Lewis*, *supra*.

8 SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) General Rule.—For purpose of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

. . . . . .

(2) Partnerships, Estates, Trusts, and Corporations.—

. . . . . .

(C) Corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

(i) such person shall be considered as owning the stock owned, directly or indirectly, by or for that corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation; and

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

. . . . . .

outstanding stock of both corporations following the stock transaction.

Petitioner contends, however, that the instant transaction "was undertaken to achieve a material and substantial corporate business purpose." It is petitioner's position that the creation of a parent-subsidiary relationship between Helix and Kerr Grain strengthened the credit position of the two corporations, facilitated the free flow of cash between the corporations, and enabled the corporations to conserve cash through the medium of filing consolidated returns.

With the exception of the consolidated returns item, we do not believe the record in this case permits the finding of a bona fide business purpose in the stock transfer. A representative of the Portland bank testified that Helix was permitted to borrow up to $500,000 for operating purposes; that, in addition, the bank had advanced $200,000 to Helix for the construction of a grain elevator; and that the bank had not requested the stock transfer as a condition precedent to future financing. Furthermore, petitioner offered no evidence that Helix or Kerr Grain were, in fact, unable to obtain adequate financing for their operations from the Portland bank

(4) Constructive Ownership as Actual Ownership.—

(A) In General.—Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3), be treated as actually owned by such person.

prior to the stock transfer. While the acquisition of Kerr Grain stock may have to some degree ultimately resulted in a strengthening of the credit position of Helix, we have not been persuaded that this was a motivating force for the transfer. Our lack of belief in petitioner's contention becomes even stronger when we observe that after the sale of stock to Helix the Portland bank still required petitioner's personal guaranty on its loans to both companies.

Lastly, aside from his bare assertion, the petitioner has not shown how under the circumstances of this case the transfer of Kerr Grain stock to Helix facilitated the free flow of cash between the two corporations.

Petitioner contends and this Court recognizes that the filing of consolidated returns by affiliated corporations often permits certain tax savings. For this reason, we are of the opinion that there may have been a minimal bona fide business purpose in the stock transfer.[9]

However, the mere existence of a single bona fide business purpose will not of itself conclusively determine that the transaction does not result in the essential equivalent to a taxable dividend. *United States v. Fewell*, 255 F. 2d 496 (C.A. 5, 1958); *Bradbury v. Commis-*

[9] The petitioner offered no evidence as to the amount or significance of the savings that the corporations purportedly hoped to obtain from the filing of consolidated returns. Consequently, this Court can only speculate as to the relative materiality of this advantage and in so doing we tend to bear most heavily against petitioner since he carries the burden of proof.

sioner, 298 F. 2d 111 (C.A. 1, 1962), affirming a Memorandum Opinion of this Court; *Kessner v. Commissioner*, 248 F. 2d 943 (C.A. 3, 1957), affirming per curiam 26 T.C. 1046 (1956); *Geneva Heiman, supra; Neff v. United States*, ___ Ct. Cl. ___ (July 18, 1962). Under the "net effect" test all factors are to be considered. *Fred B. Snite*, 10 T.C. 523 (1948), affd. 177 F. 2d 819 (C.A. 7, 1949). After considering all the factors in this case, it is the opinion of this Court that the practical effect of the stock transfer was the same as if Helix had declared and paid a dividend to petitioner.

Petitioner's argument that sections 302 and 304 are unconstitutional is predicated upon the contention that the application of these sections under the circumstances of the instant case would result in the taxation of capital rather than income and as such would be repugnant to article I, section 9, of the Constitution.[10] It is true that a return of capital is not income and may not be taxed as such. *Southern Pacific Co. v. Lowe*, 247 U.S. 330 (1918), but it is equally true that in determining whether a receipt represents income or the return of capital, the nomenclature used by the parties to the transaction is not necessarily controlling. *Commissioner v. Meyer*, 139 F. 2d 256 (C.A. 6, 1943), affirming a

[10] Art. I, sec. 9

> No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

Memorandum Opinion of this Court. In the instant case we have determined that the distribution to petitioner by Helix was not a return of his capital investment, but was the equivalent of a dividend paid out of accumulated earnings and profits of Helix. The taxation of such a distribution does not violate article I, section 9, of the Constitution.

Decision will be entered for the respondent.

2.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

THOMAS KERR and BARBARA KERR,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 18,371
Jan. 3, 1964

On Petition for Review of the Decision of the Tax Court of the United States.

Before: CHAMBERS and BARNES, Circuit Judges; and BEEKS, District Judge

BARNES, Circuit Judge

This is a petition for review of a decision of the Tax Court in favor of the Commissioner. 38 T.C. 723. The Tax Court had jurisdiction of the cause under Section 6213.[1] This court has jurisdiction of this petition pursuant to Section 7482.

The taxpayer, Thomas Kerr,[2] owned all of the stock of two corporations. On October 24, 1955, he transferred the stock of one to the other for a note with face value of $50,000. There are two issues: (1) Was the $50,000 note taxable to him as a distribution essentially equivalent to a dividend under §§ 302, 304, and other related sections of the 1954 Code? (2) If we answer this ques-

1. All references to sections are to the Internal Revenue Code of 1954 unless otherwise noted.
2. Barbara Kerr, the wife of Thomas, is involved in this suit only because they filed a joint return. Thomas is thus referred to here as the taxpayer.

tion in the affirmative, are §§ 302 and 304 constitutional?

I—FACTS

In 1947, taxpayer organized the Helix Milling Company (hereinafter "Helix") for the purpose of engaging in the business of milling and selling flour. All of the outstanding stock of Helix was acquired by taxpayer in exchange for the mill property, and taxpayer has been the corporation's president, chief executive officer, and a director, since the date of incorporation.

After its incorporation and until early 1955, Helix was operated by succeeding unrelated corporations under an arrangement whereby the latter corporations handled the financing and operation of Helix in return for a share of the profits. In early 1954, in an effort to improve and stabilize its income and to expand its operations, Helix commenced construction of a modern grain elevator as an adjunct to its flour mill. To finance this facility, Helix borrowed $200,000 from the United States National Bank of Portland ("bank") on a ten-year loan secured by a first mortgage on the grain elevator. The taxpayer gave his personal guaranty as an additional security for the construction loan.

Toward the latter part of 1954 a corporation (Cargill, Incorporated) which had been operating and financing Helix stated that it planned to withdraw its

support, and taxpayer made banking arrangements to secure funds to liquidate the debts which Helix owed the withdrawing corporation. In order to obtain loans from the bank, taxpayer executed personal notes totalling $150,000 and pledged as security for the loans his expected inheritance from the estate of a deceased relative. After taxpayer received the mony from the bank he loaned it to Helix in return for five percent demand promissory notes.

Due to the fact that several months elapsed between the time Helix first purchased the wheat and the time it received the proceeds from the sale of its flour, Helix usually found itself in a tight working capital position. Thus, Helix found it necessary to borrow money from the bank for working capital purposes. The bank considered Helix as a marginal credit risk, and required personal guaranties from the taxpayer for most of the loans.

In January, 1955, taxpayer was faced with the loss of his employment with Cargill, Inc., which had been operating and financing Helix, and he realized that he would have to seek other means of livelihood. Taxpayer then organized the Kerr Grain Corporation (hereinafter "Kerr Grain") for the purpose of engaging in the grain brokerage and grain storage business. All of the outstanding stock was acquired by taxpayer for $50,000 in cash, and at all times pertinent to this proceeding

taxpayer has been the president and the chief executive officer of the company. In forming Kerr Grain, taxpayer was hopeful that the corporation would be able to obtain business from the Federal Government, and he was aware that in the absence of such business the corporation would experience difficulty.

Following its organization, Kerr Grain, lacking sufficient working capital to finance its operations, was forced to seek outside financing. The bank extended it a credit ceiling of $150,000, and as in the case of Helix, and for the same reasons, the bank required the personal guaranty of the taxpayer as security. Helix also advanced various sums to Kerr Grain, and paid its office expenses until August 1955.

As of June 30, 1955, Helix had an earned surplus of $130,051. For the fiscal year ended June 30, 1955, Helix sustained a net *loss* of $12,498.89, and taxpayer alleges that Helix continued to sustain losses up to and including October of 1955.

Kerr Grain got off to a shaky start, and sustained a net loss of $1,886.40 for its first fiscal period which ended June 30, 1955 (the first six months of operation), but soon began to improve and as of October 1955, it had a net profit of $113,393.38.

On October 24, 1955, following discussions with his attorneys, accountants, and with representatives of the

bank, taxpayer submitted a proposal to the board of directors of Helix providing for the sale of his stock in Kerr Grain to Helix for $50,000. The board voted to accept taxpayer's proposal. Following the acceptance, taxpayer conveyed all the outstanding stock of Kerr Grain to Helix and received, in return, a promissory note for $50,000 payable in installments of $10,000 per year and bearing interest at the rate of five per cent on the unpaid balance. The note was secured by a pledge to taxpayer of the Kerr Grain stock. Taxpayer's basis for the stock on October 24, 1955, was $50,000. *The stock had a book value on that date in excess of $100,000 and a fair market value in excess of $50,000.* Helix' earned surplus then was in excess of $50,000.

At the board meeting of October 24, 1955, taxpayer also informed the directors of Helix that the bank had granted Helix an open line of credit in the amount of $100,000 and a $50,000 additional line of secured credit. At no time did the bank request that taxpayer transfer his Kerr Grain stock to Helix or that the two companies be consolidated. Nor did the bank require the transfer as a condition precedent to future financing. However, representatives of the bank did agree with taxpayer during earlier discussions that the contemplated stock transfer "may have certain advantages both credit wise and tax-wise." After the stock sale, the bank continued to require taxpayer's personal guaranty on all

operating loans it made, both to Helix and to Kerr Grain.

Following the sale of Kerr Grain stock to Helix, no curtailment of either corporation's activity was undertaken. In fact, following the sale, Kerr Grain expanded its business quite materially while Helix maintained its business on a fairly even keel until 1957 when it, too, expanded its operations.

Neither Helix nor Kerr Grain declared or paid a dividend prior to December 14, 1955. On December 14, 1955, Kerr Grain declared and paid a dividend of $33,300 to Helix. On the same date Helix paid an identical dividend to taxpayer, charging it to an account designated as "Notes Payable to Thomas Kerr." (Taxpayer alleges that the note payable referred to here was not the $50,000 note received by petitioner in exchange for the Kerr Grain Corporation stock, but, as shown by Exhibit 5-E, was one of the notes representing part of the $150,000 loaned to Helix by the bank through taxpayer.)

Kerr Grain also declared a dividend in the amount of $16,500 on June 27, 1956. On the same day the board of directors of Helix passed resolutions providing for the payment of bonuses totalling $13,500 to several of the Helix employees.

No statement or information was submitted on tax-

payer's income tax return for the year 1955 with regard to the transfer of the Kerr Grain stock to Helix. (Ex. 1-A.) The Commissioner's determination that the $50,000 of notes received by the taxpayer from Helix was taxable as *dividend income* was sustained by the Tax Court. This appeal followed.

II—THE LAW

Relevant sections of the Code.

In general, a distribution of property by a corporation to the extent of its earnings and profits is treated as a dividend and is includible in the shareholder's gross income. Sections 316(a) and 301(a) and (c). An exception to this general rule is found in § 302(a) and (b) dealing with distributions in redemption of stock.[3] Under § 302(b)(1) a redemption is not includible in gross income as a dividend if the redemption is "not essentially equivalent to a dividend." Thus, if the redemption qualifies under this exception, the distribution is treated as payment in exchange for stock under § 302(a), and since stock is generally a capital asset, the gain would be treated as a capital gain.

[3] "SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1) . . . of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) REDEMPTIONS TREATED AS EXCHANGES.

(1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend."

Taxpayer admits that § 302(b)(2) is inapplicable. Opening Brief, p. 8.)

On the other hand, if the redemption does not qualify under this exception of § 302(b), then § 302(d) provides that the redemption shall be treated as a distribution of property to which § 301 applies and be taxed at ordinary income rates. Ordinarily a redemption occurs when a corporation acquires *its* stock from a shareholder in exchange for property. Section 317(b). However, in 1954 Congress added a new provision to the Code, § 304(a)(1),[4] which was designed[5] to expand the provisions of § 115(g) of the 1939 Code (relating to stock redemptions essentially equivalent to dividends) so as to include cases of so-called "brother-sister" corporations. That section provides that, for purposes of § 302, if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation from the person or persons so in control, then such

[4] "SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

"(a) TREATMENT OF CERTAIN STOCK PURCHASES.—

"(1) ACQUISITION BY RELATED CORPORATION (OTHER THAN SUBSIDIARY).—For purposes of sections 302 and 303, if—

"(A) one or more persons are in control of each of two corporations, and

"(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then (unless paragraph (2) applies) [which it does not here] such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation."

[5] S. Rep. No. 1622, 83d Cong., 2d Sess. p. 239 (3 U.S.C. Cong. and Adm. News, 1954, 4621, 4876), reads in part: "As in the House bill, the principle of section 115(g)(2) is expanded to include cases of so-called 'brother-sister corporations.' The effect of the operation of section 304 is to characterize as redemptions distributions which are cast in the form of sales. The distributions in redemption shall be examined for taxability subject to the rules of section 302 . . . ."

property shall be treated as a distribution in redemption of the stock of the *acquiring corporation*.

In this case, taxpayer was in control of both corporations, and one of the corporations purchased his stock in the other corporation, so this transaction was covered by § 304(a)(1). Yet, the transaction results in capital gain treatment if the exception of § 302(b)(1) applies. Thus the first basic question is whether this sale of Kerr Grain stock by taxpayer to Helix was "not essentially equivalent to a dividend."

III—SCOPE OF REVIEW

The law on the issue of the scope of review is not as clear as one would desire. Since the inquiry is to a great extent a factual one, most courts of appeal hold that the ultimate decision will be sustained if supported by substantial evidence, or if not clearly erroneous. *Cf. Ballenger v. United States*, 4 Cir. 1962, 301 F.2d 192, 196 and note 8 (citing cases). Whether *all* courts actually apply that test in practice is probably doubtful. Most opinions do not indicate whether, after the test is enunciated, it is actually followed. This court has indicated in *Earle v. Woodlaw*, 1957, 245 F.2d 119, 122, cert. den. 354 U.S. 942, that it takes a wider view of the scope of its review of decisions of the Tax Court. This wider view sees determinations as to whether a certain transaction is essentially equivalent to a dividend as a

mixed question of law and fact, if not purely a conclusion of law. Of course, all courts agree that the findings of fact of the trial court will be sustained unless clearly erroneous or unless not supported by substantial evidence.

IV—TESTS TO BE APPLIED

The words "not essentially equivalent to a dividend" are words of art. They are not further defined by Congress. However, in enacting § 302(b)(1), Congress intended that the test for determining whether a redemption was "essentially equivalent to a dividend" should be the same as the test utilized in interpreting and applying the same words in § 115(g)(1) of the 1939 Code. S.Rep.No. 1622, 83d Cong., 2d Sess., p. 234 (3 U.S.C. Cong. & Admin. News (1954) 4621, 4870).

What was the test under § 115(g)(1) of the 1939 Code, and what is the test the courts have been using since in applying § 302(b)(1)?

The wording of § 302(b)(1) is "not essentially equivalent to a dividend." The question thus in each case "is one of equivalents, and, if that is present, distribution is taxable." *Earle v. Woodlaw*, *supra*, p. 129. Most, if not all the circuits, have considered the "net effect" of the transaction to be the single most important consideration. Within the "net effect" test are two

positions. One position, held in the second[6] and third[7] circuits, we describe, for convenience, as a "*strict* net effect test." If the shareholder ends up in the same position he would have if the acquiring corporation had declared and paid a $50,000 dividend, the transaction is, under the strict net effect test, essentially equivalent to a dividend. Under this test, the business purpose, motive and plans of the parties involved are irrelevant. Of course, if the strict net effect test is adopted and applied here, the decision of the Tax Court would be affirmed because the result here is just the same as would have resulted if Helix had declared a dividend.[8] The second view is the "*flexible* net effect test" which has been adopted by most courts. These have recognized that "most of (the cases arising under Sec. 115(g)) (and under § 302(b)(1)" are of little value in the determination of the question instantly presented, for the reason that each depends for its solution upon its peculiar facts." *Earle v. Woodlaw*, *supra*, at 126 (citing cases). However, under § 115(g) certain "judicial criteria" have been laid down which have proved useful in coming to a conclusion. This court listed and adopted

6. *Northrup v. United States*, 2 Cir. 1957, 240 F.2d 304; *Radnitz v. United States*, S.D.N.Y. 1960, 187 F.Supp. 952, affirmed *per curiam* 294 F.2d 577 (2 Cir. 1961).

7. *Kessner v. Commissioner*, 248 F.2d 944 (3 Cir. 1957); *Boyle v. Commissioner*, 187 F.2d 557 (3 Cir. 1951), *cert. den.* 342 U.S. 817; *Smith v. United States*, 121 F.2d 692 (3 Cir. 1941).

Also see Rives, J., dissenting in *Commissioner v. Sullivan*, 210 F.2d 607, 612 (5 Cir. 1954), who would apparently adopt this strict test.

8. Taxpayer contends that the strict net effect goes too far, but his arguments are less than convincing.

these criteria in *Earle v. Woodlaw*, *supra*, at 126, and in *Pacific Vegetable Oil Corporation v. Commissioner*, 9 Cir. 1957, 251 F.2d 682, following and citing the leading opinion of *Flanagan v. Helvering*, 1940, 73 App. D.C. 46, 116 F.2d 937, 939. In the case at bar the Tax Court adequately listed the following criteria as relevant to this case:

> "Did the corporation adopt any plan of contraction of its business activities; did the transaction actually result in a contraction of the corporation [sic] business; did the initiative for the corporate distribution come from the corporation or the shareholders; was the proportionate ownership of stock by the shareholders changed; what were the amounts, frequency, and significance of dividends in the past; was there a sufficient accumulation of earned surplus to cover distribution or was it partly from capital; and was there a bona fide corporate business purpose for the distribution?" (38 T.C. at 730.)

The Tax Court found for the Commissioner on each of these criteria. The Court found that prior to the stock transaction Helix had never paid a cash dividend, and that at the time of the transaction, Helix had accumulated earnings and profits available for the payment of dividends. Of course, the proportionate ownership was not changed because taxpayer continued to own all of the Helix stock and, under § 318(a)(2)(C), he continued also to constructively own all of the Kerr Grain stock. The Tax Court found that the business of the two

corporations had not contracted but had expanded, although the taxpayer alleges, and the Commissioner concedes (Brief, p. 22), that this criterion is not very significant in the instant situation.

The Tax Court further found that the "initiative for the stock transaction came from petitioner." Taxpayer alleges that this finding has no support in the record. His point seems to rest on the contention that the record shows, and the Commissioner admits (Brief, p. 23, note 12), "that the transaction had its beginning in the advice of business, law and tax advisors, and from the Bank." The Commissioner asserts that since we have here solely owned corporations, any advice can (or perhaps even must) be deemed personal to the taxpayer, and thus the Tax Court's finding is correct. This makes sense. The criterion of "initiative" asks only whether it was the shareholder, or the corporation, which initiated the transaction. It is hard to believe that in a solely owned corporation, initiative can come from the corporation as an entity rather than from the sole shareholder. Any other belief would fly in the face of reality. The finding of the Tax Court on this point seems not clearly erroneous.

Taxpayer places his main reliance in this appeal on his assertion that the transaction "was undertaken to achieve a material and substantial corporate business purpose." Taxpayer claimed below and claims here

that the creation of a parent-subsidiary relationship between Helix and Kerr Grain strengthened the credit position of the two corporations, facilitated the free flow of cash between the corporations, and enabled the corporations to conserve cash in taxes through the filing of consolidated returns.

Concerning the strengthening of the credit position of the two companies, the Tax Court pointed out that Helix had been given much credit already by the bank. The Court continued:

> "The bank had not requested the stock transfer as a condition precedent to future financing. Furthermore, petitioner offered no evidence that Helix or Kerr Grain were, in fact, unable to obtain adequate financing for their operations from the Portland bank prior to the stock transfer. While the acquisition of Kerr Grain stock may have to some degree ultimately resulted in a strengthening of the credit position of Helix, we have not been persuaded that this was a motivating force for the transfer. Our lack of belief in petitioner's contention becomes even stronger when we observe that after the sale of stock to Helix the Portland bank still required petitioner's personal guaranty on its loans to both companies." (38 T.C. at 731.)

Taxpayer claims that this finding of the Tax Court was clearly erroneous. Taxpayer points out that the two corporations continually were in need of credit, that the general loan officer of the bank testified that a stronger credit position exists in parent-subsidiary than

in brother-sister situations; that credit would be also strengthened by the tax savings obtained by filing consolidated returns; that it is sound and prudent business practice to strengthen one's credit position *before* one's credit is otherwise cut off; and that several cases have held that the improvement of credit position defeated a charge of dividend equivalence. Taxpayer cites *Joines v. Griffin*, 10 Cir. 1954, 216 F.2d 885 (*preferred stock with dividend arrearages* redeemed to obtain bank loan at small interest rate *and for other reasons*); *Bona Allen, Jr.*, 1940, 41 BTA 260 (corporation's indebtedness to shareholders reduced by partial redemption in order to obtain bank loan at low interest; *the bank insisted that the indebtedness be reduced*); and Isaac C. Eberly, 1951, 10 CCH Tax Ct. Mem. 1157, which is in point with similar facts.

In answer to these contentions of the taxpayer, the Commissioner contends that the only advantage a parent-subsidiary relationship has over a brother-sister relationship is that if the parent defaults on a loan, the lender can go against the stock of the subsidiary. The Commissioner points out that in this situation the bank could have obtained more effective security by having the taxpayer pledge the Kerr Grain stock. Taxpayer replies that the pledge device has special problems of foreclosure.

The Commissioner also points out that the strengthening of credit argument can be used in any and every brother-sister redemption, and if successful, could thus "sap Section 304 of its vitality." Taxpayer replies to this that not every corporation has the credit and cash problems that Helix and Kerr Grain had.

Considering these opposing allegations and the points made by the trial judge, we cannot conclude that the trial judge erred in finding that the strengthening of credit argument, in itself, was *not* a sufficient corporate business purpose to put the transaction within the exception of § 302(b)(1). This is especially true when one considers the facts that (1) the trial judge was able to observe the bank officer on the stand when he testified; (2) that almost every company needs or could need a stronger credit position; and (3) that at least two circuits have found that the strengthening of credit is not a valid reason for avoiding ordinary income treatment in redemptions. Cf. *Bradbury v. Commissioner*, 1 Cir., 1962, 298 F.2d 111; *United States v. Fewell*, 5 Cir. 1958, 255 F.2d 496. Moreover, if Helix was so concerned about its credit, why did it issue notes instead of stock to the taxpayer? The issuance of notes would make its credit standing worse instead of better. A bank would ordinarily prefer the cushion of an additional common stock issue to the issuance of notes by a corporation, with their priority over stock.

As to the taxpayer's argument that the transaction would improve the cash flow between the corporations, the Tax Court said:

> "Lastly, aside from his bare assertion, the petitioner has not shown how under the circumstances of this case the transfer of Kerr Grain stock to Helix facilitated the free flow of cash between the corporations." (38 T.C. at 731-732.)

In reply to this, taxpayer points out that there is evidence in the record, and the Tax Court found, that Kerr Grain paid two dividends to Helix. Taxpayer also points out that when consolidated returns are filed, there is no income tax on the intercorporate dividends, as opposed to the regular fifteen per cent tax of § 243. However, such facilitation of the free flow of cash is always a result of brother-sister redemptions. Many if not all corporations have working capital problems, especially the small, closely held corporations with which § 304 is concerned. One can read the statement of the Tax Court as meaning that even though dividend advantages exist, the taxpayer has not carried his burden of proof of showing that the circumstances of this case are different from other "brother-sister" redemptions. It is thus very doubtful whether the purported business purpose of facilitating cash flow should, in and of itself, take the transaction out of the ordinary income category.[8]

Taxpayer urges a strong point proving a substantial business purpose in emphasizing that the two corporations obtained an immediate tax savings of $31,022.53 in 1956 and $14,499.43 in 1957 by filing consolidated returns rather than separate returns for those years. The Tax Court found:

> "Petitioner contends and this Court recognizes that the filing of consolidated returns by affiliated corporations often permits certain tax savings. For this reason, we are of the opinion that there may have been a *minimal* bona fide business purpose in the stock transfer." (Emphasis added. 38 T.C. at 732.)

The Tax Court added in a footnote:

> "The petitioner offered *no evidence* as to the amount or significance of the savings that the corporations purportedly hoped to obtain from the filing of consolidated returns. Consequently this Court can only speculate as to the relative materiality of this advantage and in so doing we tend to bear most heavily against petitioner since he carries the burden of proof." (Emphasis added. 38 T.C. at 732, n. 9.)

The Tax Court apparently overlooked these corporate returns in using the words "no evidence."

Taxpayer suggests that this court can take judicial notice of the substantiality of the tax savings obtained by the filing of consolidated returns. We need not do this, because the savings are part of the record. Tax

savings of $45,521.96 in two years for these two corporations are obviously substantial, compared to the "sale" price of $50,000. The question of substantiality would thus not have to be remanded to the Tax Court for further consideration, were we to hold the tax savings alone a sufficient reason to find a business purpose.

The question is: Did Congress intend that the provisions of §§ 302 and 304 could be avoided any time a corporation with substantial losses acquired a corporation with substantial gains? If so, large loopholes would be created in those sections. Oftentimes taxpayers who own the stock of two or more corporations have loss as well as gain corporations. These taxpayers could obtain cash from these corporations without realizing ordinary income, even though they retained sole control of both corporations, just by selling the stock of one to the other. But even if the loophole only existed in the sale of gain to loss corporations, and then only when the tax savings were substantial, the loophole would still be a large one in the statutory scheme of Congress of §§ 302 and 304.

Furthermore, the savings would not be so substantial in the long run as the figures might indicate because the taxpayer received notes which in face value surpassed the value of these savings in the first two years, almost in one year. If the corporations really needed these savings as badly as the taxpayer alleges,

it would not have immediately issued good faith notes. Instead, it would have issued stock. Even though the savings were more immediate than the payment by the corporation on the notes, there is no indication that the two corporations were in dire need of cash. And they apparently could have obtained it from the bank, had they needed it badly.

Moreover, the Tax Court in its opinion pointed out that:

> "[T]he mere existence of a single bona fide business purpose will, not of itself conclusively determine that the transaction does not result in the essential equivalent to a taxable dividend. United States v. Fewell, 255 F.2d 496 (C.A. 5, 1958) (discharge shareholder's debt by redemption to improve credit); Bradbury v. Commissioner, 298 F.2d 111 (C.A. 1, 1962) (redemption to cancel debt to shareholder to get bank loan), affirming a Memorandum Opinion of this Court; Kessner v. Commissioner, 248 F.2d 943 (C.A. 3, 1957), affirming per curiam 26 T.C. 1046 (1956) (does not really so hold); Genevra Iselman, supra (32 T.C. 479 (1959), affirmed 283 F.2d 227 (8th Cir. 1960)) (two shareholders: one dies and his debt to corporation ended by redemption of his preferred shares); Neff v. United States, 305 F.2d 455 (Ct. Cl. 1962) (redemption of some shares to be resold to raise capital for corporation)." (38 T.C. at 732.)

To the same effect is *Ortmayer v. Commissioner*, 7 Cir. 1959, 265 F.2d 848, 853. Moreover, after an exhaustive review of the cases, the fourth circuit stated:

> "In the case of a pro rata redemption of stock especially, any business justification must be indeed compelling to overcome the 'net effect' test which points to a tax avoidance scheme." *Ballenger v. United States*, 1962, 301 F.2d 192 at pp. 199-200.

Considering the facts of this case, it does not seem that the purposes which allegedly motivated this transaction are "compelling," nor in the terms of the first circuit in *Bradbury v. Commissioner*, *supra*, at 119, are these purposes "conspicuously countervailing considerations." Furthermore, the words of Judge Learned Hand are relevant to the significance of business purposes:

> "[W]e think that Commissioner v. Estate of Bedford, supra, 325 U.S. 283, 65 S.Ct. 1157, has authoritatively overruled the doctrine that the distribution of accumulated earnings in the cancellation or redemption of shares can never be 'essentially equivalent' to the payment of a dividend, if the shares were originally issued for a bona fide corporate purpose; i.e. for a purpose other than to evade taxation." *Kirschenbaum v. Commissioner of Internal Revenue*, 2 Cir. 1946, 155 F.2d 23, 24, cert. den. 329 U.S. 726.

Summing up petitioner's case, of the three purported business purposes, the first two are extremely weak, and the third has its faults. Thus, even in aggregate, there is serious doubt whether these are sufficient to constitute a business purpose which would move a

court to allow the taxpayer to escape ordinary income treatment here.

Apparently the cases which discuss the business purpose criterion believe that if there exists a substantial business purpose for the transaction, this negates or at least weakens a conclusion that there was an intent to bail out earnings and profits via the redemption of stock. There are many cases which discuss business purpose, and taxpayer cites nineteen cases for the proposition that:

> "In almost every instance where it was found that the redemption transaction was not essentially equivalent to a dividend, a bona fide business purpose was found to exist." (Opening Brief, p. 24.)

In eighteen of those cases, at least one of the following factors was emphasized by the court: (1) the shares of the taxpayer involved were all redeemed; (2) the redemption was not pro rata; (3) there was a contraction of the corporate business; (4) lenders insisted that the shareholders do something which insistence prompted the redemption; (5) the stock was redeemed to avoid possible friction with other parties; (6) preferred shares with dividend arrearages were redeemed to end the arrearages; (7) shares were redeemed so as to be available for sale to a key employee who demanded some shares; (8) the redeemed shares had been originally

issued to cancel a debt and at the time of the issue there was manifested an intention to redeem the shares. (This latter purpose was not considered substantial enough in *Ballenger v. United States*, *supra*.) Some of these distinctions obviously are more substantial than others. It is conceivable that some courts might find for the taxpayer on the facts here present. However, the opinions most favorable to taxpayer's position were appellate decisions affirming trial court opinions. This fact alone sheds substantial doubt on the applicability of the eighteen cases to the case at bar when before us on appeal on a question of fact after an adverse decision to taxpayer below. There thus remains substantial doubt whether most of the courts which decided the cited cases would go so far as to allow taxpayer here to escape ordinary income treatment.

One case cited by taxpayer is very similar to the present case and deserves mention. *Isaac v. Eberly*, 10 CCH Tax Ct. Mem. 1157 (1951) holds that a pro rata redemption of some of the shares of a corporation to cancel one-half of a shareholder's indebtedness to the corporations was not essentially equivalent to a dividend under § 115(g) of the 1939 Code because credit was the lifeblood of the corporation, the credit standing of the corporation would be improved even though credit was not immediately needed but because prudent business practice dictated planning ahead, and because there

was no cash available to pay a dividend. One Tax Court memorandum opinion is not enough in itself to move this court to decide in favor of taxpayer, especially (1) when there is a substantial doubt as to the aid which the transaction here gave to the credit standing of the corporation, and (2) when the transaction increased rather than decreased the indebtedness of the corporation to the shareholder.

It must be remembered that the business purpose of a transaction is *only one* of the criteria to be considered in the weighing process of the flexible net effect test. It must be remembered that the other criteria already discussed weigh against the taxpayer.

The final criterion, *and by far the most important*, is the net effect of the transaction: the result. It is not the "strict" test, because other criteria are considered also, but it is necessary to closely approach the "strict" test because the courts attach by far the most weight to this criterion. In *Hirsch v. Commissioner*, 124 F.2d 24, 29, this court stated that the purpose of the transaction to secure favorable interest rates at the bank was irrelevant because "the statute is aimed at the result." In *Earle v. Woodlaw*, *supra*, this court stated:

> "Some of the earlier cases, emphasizing that a question of fact is involved, also urge that the intent of the directors of the corporation is to be considered. . . . But later cases place the emphasis on the *effect* of the distribution as that which controls, and

not the intent nor the motives, either of the taxpayer or the corporation." *Id.* at 129.

Emphasis on net effect is even more important where the corporations are solely owned, as here.

> "[S]ince it often happens that the corporation is closely held and the stockholders and corporate officers are the same people, courts following the second approach [flexible] find it almost impossible to untangle the various purposes to say with any assurance that the redemption was justified by a legitimate business purpose. Recourse in such circumstances should be to the factors emphasizing the net effect of the transaction if the statute is to be reasonably applied." *Ballenger v. United States supra*, 198. Accord, *Bradbury v. Commissioner, supra.*

The Tax Court followed a flexible test, but placed the heaviest emphasis on the net effect of the transaction. The Court said:

> "Under the 'net effect' test, all factors are to be considered. * * * After considering all the factors in this case, it is the opinion of this Court that the practical effect of the stock transfer was the same as if Helix had declared and paid a dividend to petitioner." (38 T.C. at 732.)

There can be no question that the result of this transaction is to the taxpayer the same as it would have been if Helix had declared and paid a dividend. Tax-

payer received the notes and he still retained 100% of both corporations. As the district court stated in *Radnitz v. United States*, S.D.N.Y. 1960, 187 F. Supp. 952, affirmed per curiam 294 F.2d 577:

> "After the dust has settled, one finds the plaintiffs and their fellow stockholders as firmly ensconced in their tricorporate positions as was true prior to the stock transaction, with admittedly no true diminution of interest or control, despite their transfer of stock." (*Id.* at 958. Quoted with approval in *United States v. Collins*, 1 Cir. 1962, 300 F.2d 821 at 824-825.)

g.

Taxpayer alleges that there is a difference between a person's owning the stock of "X" corporation and his owning the stock of "Y" corporation which in turn owns the stock of "X" corporation. That is true, as a factual and technical matter, but the Congress "in its wisdom" has decided that the differences are not as great as the similarities, and thus, under § 318(a)(2)(C), the taxpayer is constructively presumed to own the Kerr Grain stock even though it is actually owned by Helix.[10]

A further contention of taxpayer can be disposed of

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9 Although, as taxpayer points out, notes rather than cash were distributed here, the weight of case law favors treating such notes as cash.

10 It is true, as taxpayer contends (Opening Brief, pp. 40-41), that the Commissioner here is thus contending that Helix exists for dividend purposes but not for control purposes. However, this latter contention seems sound because the ownership of Kerr Grain by Helix rather than by taxpayer lacks much in the way of any real or practical consequence. *United States v. Collins*, 1 Cir. 1962, 300 F.2d 821, 824. Besides, that is what Congress intended to do in § 304.

by a quotation from the district court opinion in *Badnitz, supra*:

> "Plaintiffs urge the court that Congress sought merely to prevent those distributions which reduced corporate assets from escaping dividend equivalence liability; that since Tylon received assets it did not previously own, viz., stock in New Jersey Turner Hall, in return for the cash payments made to plaintiffs and others, no corporate assets of Tylon were depleted. However, to subscribe to these contentions would serve to frustrate the corporate tax policy exemplified by the inclusion of Section 304 in the 1954 Internal Revenue Code and to impute to Congress a limited purpose therein unwarranted by the terms of the Code or its legislative background." *Badnitz v. United States*, *supra* at p. 959; quoted with approval in *United States v. Collins*, *supra*, at 824.

In *Phelps v. Commissioner*, 1957, 247 F.2d 156, 158, this court in finding that the taxpayer received a taxable dividend, pointed out that although the purported business purpose could have been accomplished other than by a method similar to a dividend, "the net result of the plan adopted, however, was the transfer of accumulated earnings and profits to Phelps and Howell."

In *Ballenger v. United States*, *supra* at 199-200, the court stated in reply to the contention that there were legitimate business reasons for the transaction,

> "Nevertheless, these objections could be remedied without at the same time effecting a distribution of

corporate earnings at capital gains rates. The taxpayer could as readily have caused the preferred stock to be exchanged for common stock . . . ."

Where a shareholder picks a "sale" device rather than a "stock for stock" device, an appearance of tax avoidance is given. A taxpayer should not be allowed to avoid the statutory scheme when he could have accomplished all the business purposes he purports to have wished to accomplish, without in effect obtaining a dividend.

We affirm the Tax Court.

V—CONSTITUTIONALITY

Taxpayer contends that if §§ 304 and 302 are found to be applicable to this transaction such as to tax the taxpayer at ordinary income rates, such application is unconstitutional under Article I, Section 9, Clause 4 of the Federal Constitution which prohibits a direct property tax unless apportioned among the states. Taxpayer claims that this is just a return of the taxpayer's investment, which cannot be taxed as "income" under the Sixteenth Amendment, citing *Southern Pacific Co. v. Lowe*, 1918, 247 U.S. 330; *Commissioner v. Meyer*, 8 Cir. 1943, 139 F.2d 256. Also, *Bowers v. Kerbaugh*, 1926, 271 U.S. 170.

The argument that this transaction was just a return

of an investment, is difficult to accept. After the transaction, taxpayer still retained control of the Kerr Grain stock, and to all intents and purposes he still owned it, this time its being held indirectly through Helix and not held directly by him. In literal terms he did give up certain rights attendant to direct control of the shares, but realistically he could, through his control of Helix, still deal with Kerr grain as he pleased. Under these circumstances it is difficult to agree that taxpayer gave up his investment. This transaction looks, as we have decided, much more like a payment of surplus earnings than a return of an investment.

Taxpayer endeavors to equate this transaction with the sale of an asset, such as a warehouse, to Helix. Yet, could not Congress make such a transfer taxable, just as § 304 makes a transfer of certain stock taxable, at ordinary income rates? It seems that Congress could, because the only practical effect of such a sale of a warehouse is that the taxpayer receives cash and he still owns or controls the asset which he purportedly sold.

Taxpayer asserts that if the promissory note is but a return of his investment and not a dividend, then tax on it would be unconstitutional. But if it were not a dividend, and hence an investment (contrary to the holding of the Tax Court below), the constitutionality issue would never be and need not be reached. Thus, as the government brief states, nothing is added to the

case by the constitutionality argument. Taxpayer replies that his constitutional argument is intentionally misunderstood because "the mere labeling of the distribution as a dividend does not make it so." We agree. But the Tax Court did more! It not only found as a matter of fact and law the distribution was not income, it was a dividend, or the equivalent thereof. This does more than call it a dividend, it makes it the equivalent of one.

Further any court, other than the Supreme Court, should not find unconstitutional a statute (or its equivalent) which has been on the books for many years, except in the clearest of cases. *Kronberg v. Hale*, 9 Cir. 1950, 180 F.2d 128 at 131, cert. den. 339 U.S. 969.

We hold the provisions attacked are constitutional.

On petition for review, the decision of the Tax Court for respondent Commissioner of Internal Revenue is *Affirmed*.

(Endorsed) Opinion Filed January 3, 1964.

Frank H. Schmid, Clerk

B. CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

1. Constitutional Provisions

Article I, Section 9, Clause 4

"No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

Amendment XVI

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

2. Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . . .

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a

dividend (as defined in section 316) shall be included in gross income.

* * * * *

(26 U.S.C. 1958 ed., Sec. 301.)

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated As Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

* * * * *

(5) *Application of paragraphs.*—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4), shall not be taken into account.

* * * * *

(d) *Redemptions Treated As Distributions of Property.*—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * *

(26 U.S.C. 1958 ed., Sec. 302.)

SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

(a) *Treatment of Certain Stock Purchases.*—

(1) *Acquisition by related corporation (other than subsidiary).*—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

* * * * *

(b) *Special Rules For Application Of Subsection (a).*—

(1) *Rule for determinations under section 302(b).*—In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a) (relating to constructive ownership of stock) with respect to section 302(b) for purposes of this paragraph, section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained therein.

(2) *Amount constituting dividend.*—

(A) *Where subsection (a)(1) applies.*—In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.

* * * * * * *

(c) *Control.*—

(1) *In general.*—For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) *Constructive ownership.*—Section 318(a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1). For purposes of the preceding sentence, section 318(a)(2)(C) shall be applied without regard to the 50 percent limitation contained therein.

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. . . .

. . . . . .

(26 U.S.C. 1958 ed., Sec. 316.)

SEC. 317. OTHER DEFINITIONS.

(a) *Property.*—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) *Redemption Of Stock.*—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

(26 U.S.C. 1958 ed., Sec. 317.)

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) *General Rule.*—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

* * * * *

(2) *Partnerships, estates, trusts, and corporations.*—

* * * * *

(C) *Corporations.*—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, then—

(i) such person shall be considered as owning the stock owned, directly or indirectly, by or for that corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation; and

(ii) such corporation shall be considered as owning the stock owned, directly or indirectly, by or for that person.

* * * * *

(4) *Constructive ownership as actual ownership.*—

(A) *In general.*—Except as provided in subparagraph (B), stock constructively owned by a person by reason of the application of paragraph (1), (2), or (3) shall, for purposes of applying paragraph (1), (2), or (3), be treated as actually owned by such person.

* * * * *

(26 U.S.C. 1958 ed.; Sec. 318.)

SEC. 346. PARTIAL LIQUIDATION DEFINED.

(a) *In General.*—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

* * * * *

(26 U.S.C. 1958 ed., Sec. 346.)

C. OUTLINE OF DECISIONS

First Circuit

The "ultimate question is whether the surrender of the shares is an economically meaningful gesture or a sterile exercise in formalism." *Bradbury v. C.I.R.*, 298 F.2d 111, 114 (1962). The answer depends primarily on whether the distribution was substantially disproportionate (i.e. essentially not pro rata after the distribution). Although the decisions under the 1954 Code state that other factors such as the presence of a corporate business purpose, clearly distinguished from a shareholder purpose, may be relevant, such other factors appear to have little if any weight. *Bradbury v. C.I.R.*, *supra*; *U.S. v. Collins*, 300 F.2d 821 (1962).

Second Circuit

Applies the so-called "strict net effect test." *Radnitz v. U.S.*, 187 F.Supp. 952 (D.C.S.D. N.Y., 1960), aff'd per curiam 294 F.2d 577 (2d Cir., 1961). However, doubt is cast on the correctness of this conclusion by the most recent case in this circuit, *McGinty v. C.I.R.*, 325 F.2d 820 (2d Cir., 1963). In its opinion in *McGinty* the court, immediately following the language quoted on page 9 of this petition, said the following at pages 821-822:

> "The Committee Report indicates that the determinative question in considering whether a redemption is not essentially equivalent to a dividend is

whether the transaction may be characterized as a sale of stock to the corporation, and that the tests to be applied are, in general, those developed under section 115(g) of the 1939 Code. By far the most important of these tests was whether the redemption was substantially pro-rata—i.e., did it significantly affect the interest which the redeeming shareholder has in the corporation. We think this factor continues to be of greatest weight in interpreting § 302(b)(1), although § 302(b)(3) contains a specific 'safe harbor' based on the reduction of a shareholder's proportionate interest. Many courts also gave weight to the question whether there was a genuine corporate business purpose for the transaction. However, we have minimized the importance of this factor in Northup v. United States, 2 Cir., 240 F.2d 304 (1957), and see little reason to accord more weight to it under the 1954 Code than under the predecessor statute.

Third Circuit

No decisions under the 1954 Code but follows the "strict net effect" approach. "It is the effect of the redemption, rather than the purpose which actuated it, which controls the determination of dividend equivalence." *Kessner v. Comm'r*, 248 F.2d 943, 944 (1957).

Fourth Circuit

Classifies the decisions into two categories but has not chosen between the two. It considers as one approach the "strict net effect" test in which every pro rata redemption must be equivalent to a dividend. The

second approach involves the consideration of other factors such as business purposes and purity of motive. *Ballenger v. U.S.*, 301 F.2d 192 (1962). The question of contraction of the business is limited to a determination of qualification as a partial liquidation under Section 346 (Ibid 195) and not as a criteria of dividend equivalence.

Fifth Circuit

No decisions under the 1954 Code but follows the approach of examining pertinent criteria substantially similar to those employed by the courts below. *U.S. v. Fewell*, 255 F.2d 496, 500 (1958).

Sixth Circuit

Decisions involving 1954 Code and prior law merely place the stamp of approval on the Tax Court approach. *C.I.R. v. Decker*, 286 F.2d 427 (1960). In the *Decker* case the Tax Court made no distinction between redemptions which were made in parts under the 1939 Code and the 1954 Code.

Seventh Circuit

No decisions under the 1954 Code but follows the rule that all facts and circumstances of the case must be considered to determine the net result therefrom and no one factor is entitled to greater weight than any

other judicial criteria, similar to those expressed by the courts below, are employed. *Commissioner v. Spitz*, 177 F.2d 819 (1949).

Eighth Circuit

The question is one of fact to be determined by applying the judicial criteria developed by the courts. Although there is no sole decisive test, the "net effect" is the most important consideration. *U.S. v. Carey*, 289 F.2d 531 (1961); *Idol v. C.I.R.*, 319 F.2d 647 (1963). The opinion in *Carey* demonstrates quite clearly that contraction of the business is no longer properly an element of determining essential equivalence although *Idol* lists it among the criteria.

Ninth Circuit

The question is a mixed question of fact and law to be determined in light of the judicial criteria, but the most weight is to be given to the "net effect." (*infra* Appendix 35).

Tenth Circuit

No decisions under the 1954 Code. The question is one of fact to be determined by applying the judicial criteria developed by the courts. Although there is no sole decisive test the "net effect" is the most important consideration. *Jones v. Griffin*, 210 F.2d 885 (1954).

District of Columbia Circuit

No decisions under the 1954 Code. The question is one of fact to be determined by applying the judicial criteria developed by the courts. Although there is no sole decisive test the "net effect" is the most important consideration. *Flanagan v. Helvering*, 116 F.2d 937 (1940).

Court of Claims

Appears to follow the "strict net effect" approach, although possibly considers other factors such as business purpose. *Neff v. U.S.*, 301 F.2d 330, reconsidered, 305 F.2d 455 (1962).

Tax Court

It is difficult to determine precisely what test is employed by the Tax Court. The majority opinion in the recent *Sorem* case, 40 T.C. No. 25 (1963), states that they employed the evidentiary criteria useful under prior law, although it also concluded that the three specific tests ("safe harbors") of Section 302(b)(2), (3) or (4) may not be taken into account. Judge Dawson in his strong dissent appears to be of the opinion that the majority did not heed the last statement but considered criteria not properly pertinent under the 1954 Code.